

***United States Court of Appeals
for the Second Circuit***



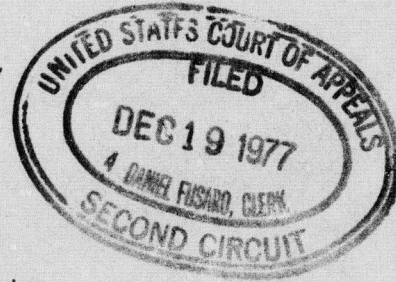
APPELLEE'S BRIEF

77-5019

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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p/s

In the Matter of
STIRLING HOMEX CORPORATION,
Debtor,
GREGORY JEZARIAN, et al.,
Appellants.



Appeal from the United States District Court
for the Western District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION,
APPELLEE, IN SUPPORT OF REVERSAL OF JUDGMENT BELOW

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Nos. 77-5019 and 77-5022 (consolidated)

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STIRLING HOMEX CORPORATION,
Debtor,
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Appellants.

Appeal from the United States District Court
for the Western District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION,
APPELLEE, 1/ IN SUPPORT OF REVERSAL OF JUDGMENT BELOW

QUESTION PRESENTED

Whether the claims of holders of shares of preferred and common stock of a debtor under Chapter X of the Bankruptcy Act, who were allegedly defrauded into purchasing those shares, should be classified as subordinate to those of debtor's unsecured creditors for purposes of the plan of reorganization and its acceptance.

1/ The Securities and Exchange Commission has been participating in this reorganization proceeding in the district court, pursuant to Section 208 of Chapter X of the Bankruptcy Act, 11 U.S.C. 608, since shortly after the commencement of the proceeding (JA I 156). While the Commission has no right of appeal under that section, as a party to the proceeding the Commission is an appellee in appeals brought by others. In re Postal Telegraph & Cable, 119 F.2d 861, 862 (C.A. 2, 1941); In re Imperial '400' National, Inc., 432 F.2d 232, 234 (C.A. 3, 1970); Ashbach v. Kirtley, 289 F.2d 159, 162 (C.A. 1961); cf. Scribner & Miller v. Conway, 238 F.2d 905, 906 (C.A. 2, 1956); In re American National Trust, 426 F.2d 1059, 1066 n. 6 (C.A. 7, 1970).

STATEMENT OF THE CASE

These are appeals from an order (JA II 440-446) 2/ entered on July 27, 1977, by the United States District Court for the Western District of New York (Burke, J.), in a proceeding for the reorganization under Chapter X of the Bankruptcy Act, 11 U.S.C. 501, et seq., of Stirling Homex Corporation ("Stirling Homex" or "debtor"). That order held (JA II 446) that claims of stockholders based on alleged violations of the federal securities laws are subordinate to those "of conventional general creditors."

Stirling Homex was engaged in the manufacture, sale, and installation of modular housing units for multi-family townhouses and apartments. (JA I 157; JA II 352). Its stock was sold to public investors in two offerings. On February 19, 1970, Stirling Homex sold 400,000 shares of common stock at \$16.50 per share; the net proceeds to the debtor approximated \$6,100,000. (JA I 157, 158.) These funds were to be used in the debtor's business (JA I 158). At the same time, certain stockholders sold an additional 775,000 shares at the same price. On July 29, 1971, the debtor sold 500,000 shares of convertible preferred stock at \$40 per share, from which it realized about \$19,000,000. (JA I 157, 158; JA II 282, 346, 348, 422.) The proceeds of this latter offering were to be used to reduce then outstanding short-term borrowings from banks aggregating \$37,450,000 at June 30, 1971 (JA II 348).

2/ The first volume of the joint appendix is cited as "JA I __," and the second volume as "JA II __." References to documents filed in the court below, which are not in the joint appendix, are cited to the docket sheets which are part of the appendix.

Stirling Homex had banking relationships with a consortium of nine banks, and, on July 12, 1972, when the Chapter X proceeding was initiated, it owed these banks about \$38,000,000 (JA I 157, 168).

When these loans were being made and when its securities were being sold and traded, Stirling Homex appeared to be a successful business, reporting increasing sales of modules and installations during at least 1970 and 1971 (JA I 158; JA II 282, 350, 375). This rosy picture led to an active over-the-counter trading market in debtor's preferred and common stock prior to the commencement of this reorganization proceeding (JA I 157). From the date of the public offering in February, 1970, at \$16.50 per share, the bid price of the common stock rose to a high of about \$52 in July, 1971, when the preferred stock was sold to the public.

On July 12, 1972, Stirling Homex filed its petition for reorganization under Chapter X (JA I 1). The petition was approved, and a trustee was appointed (id.). The trustee determined at the outset that, without additional financing, which he was unable to obtain, it would not be possible to continue the debtor's business or to formulate a reorganization plan under which Stirling Homex would continue as a viable business (JA I 69-70, 159, 174). Accordingly, he embarked on an asset disposition program, primarily of modules that had not been sold by the debtor (JA I 161-163). In addition to cash on hand of \$6,236,742, and \$7,000,000 previously paid to the consortium of banks (see n. 3, infra), the debtor's remaining assets are estimated to be worth \$3,749,634 (JA I 188, 201), excluding any recoveries that might result from lawsuits that have been brought on behalf of the debtor (JA I 204-207). The claims to which the trustee has not objected aggregate \$45,961,000,

including the total claims of the banks 3/ but excluding substantially all stockholder claims based on alleged violations of the antifraud and reporting provisions of the federal securities laws (JA I 166, 188, 203).

In his report, pursuant to Section 167(1) of Chapter X, 11 U.S.C. 567(1), the trustee states that in its operations Stirling Homex had required vast amounts of cash (JA I 158). In order to obtain the amounts necessary, the debtor had distorted its financial statements by, among other things, assuming sales had occurred when potential customers were identified but before sales were actually made (id.). Another distortion was created by assuming profits on the modules that did not take into account subsequent losses that would occur on the site work (id.). 4/

3/ The banks asserted a security interest in the debtor's inventory and receivables for their claims aggregating about \$38,000,000 (JA I 53, 77, 111, 168). The trustee denied that those claims were secured (JA I 53, 112, 168). As a result of negotiations between the banks and the trustee the following compromise was reached: the banks agreed to waive any security interest they may have had in the debtor's assets and withdraw their objection to a consolidation of the estates of Stirling Homex and its subsidiaries, in return for which the trustee agreed to make an interim payment of \$7,000,000 on account to the banks, an early distribution of a portion of the amount they were expected to receive under the reorganization plan (JA I 53-57, 112, 168). After a hearing (JA I 61), on notice as directed by the bankruptcy court (JA I 52), and no objections having been filed (JA I 106, 109, 113), a bankruptcy judge, sitting as special master (JA I 109), recommended approval of the settlement (JA I 114, 168-169). Subsequently, a hearing, on notice (JA I 116), was held before the district court (JA I 125), and no one objected (JA I 140). The court, by order dated June 29, 1976, confirmed the report of the bankruptcy judge and approved the settlement and directed the trustee to pay \$7,000,000 to the banks and allowed their total claims as unsecured claims (JA I 142-145, 169).

4/ Most of the charges had been set forth in a complaint filed by this Commission, on July 2, 1975, in an injunctive action in the United States District Court for the District of Columbia, in which it alleged that Stirling Homex and others had violated antifraud and reporting provisions of the federal securities laws by issuing false and misleading financial statements. The defendants, without admitting or denying the allegations in the Commission's complaint, consented to the entry

A class action on behalf of the debtor's stockholders ("Jezarian action") has been brought based on the debtor's fraud in the sale of its stock, 5/ and some claims have been filed in the Chapter X proceeding based on that fraud (JA I 166, 184).

4/ (footnote continued)

of permanent injunctions against further violations of those provisions. Securities and Exchange Commission v. Stirling Homex Corporation, et al. (D. D.C., Civil Action No. 75-1065). See Litigation Release No. 6960 (July 2, 1975) (JA II 275-276). In addition, the Commission issued a report of its staff's investigation in which it was critical of the activities of two outside members of the Stirling Homex board of directors (Securities Exchange Act Release No. 11516 (July 2, 1975)) (JA II 279). The Commission also issued its Accounting Series Release No. 173 (July 2, 1975) (JA II 281-297), in which the Commission concluded that the debtor had issued false and misleading financial statements (JA II 282, 283, 288-294). The Commission specifically noted, for example, that to support the recognition of 62.8% of module revenue on one project for the seven month period ended February 28, 1971, Stirling Homex showed its auditors forged documents "which purported to represent a commitment of government financing for \$15 million" (JA II 288).

Indictments were returned in 1976 against certain officers and directors of Stirling Homex. United States v. Stirling, et al., S.D. N.Y., No. 76 Crim. 685(MEF) (JA II 299). Many of the charges related to the false and misleading financial statements and reports issued by the debtor (JA II 301-304, 317-323). The defendants were convicted, on January 19, 1977, following a jury trial and verdicts of guilty on all counts (JA II 270). The defendants appealed to this Court which has heard oral argument and has the matter sub judice (Docket No. 77-1140).

5/ In April, 1972, prior to the filing of the Chapter X petition of the debtor, a class action (JA II 335) was filed against Stirling Homex and others, on behalf of stockholders who purchased its shares between March 16, 1971, and March 20, 1972 (JA II 336, 338), Jezarian v. Csapo, et al., S.D. N.Y., No. 72 Civ. 1671(DBB). It was alleged, among other things, that during that period Stirling Homex had issued to the public materially false and misleading financial statements and reports that overstated revenues, profits, assets, and stockholders equity and understated liabilities (JA II 338-342). The plaintiffs sought, inter alia, an unspecified amount of monetary damages (JA II 344). That complaint subsequently was consolidated with other actions and amended (JA II 417), among other respects, to allege that materially false and misleading information about Stirling Homex was disseminated to the public during the period from October 7, 1970, through July 10, 1972 (JA II 423-429). Because of the stay order entered by the reorganization court prohibiting, among other things, the continuation of lawsuits against the debtor, Stirling Homex is no longer a defendant in that action (JA II 412).

A hearing was held on June 13, 1977, to determine whether Stirling Homex was solvent and, for "purposes of the plan and its acceptance," to classify creditors according to the nature of their claims (JA I 149, 196-197, 210). 6/ The reorganization judge found that the liabilities of the debtor far exceeded its assets, and, accordingly, he declared the debtor insolvent (JA I 210; JA II 267). Consequently, under the absolute priority rule the debtor's stockholders, as such, are not entitled to participate in any plan of reorganization. See pages 9-10, infra. With respect to classification of creditors, the trustee requested that the court determine whether claims of stockholders based on alleged violations of the federal securities laws should "be included [in the reorganization plan] on a pari passu basis" with those of "the orthodox or conventional,

ordinary creditors" (JA I 211; JA II 442).

At that hearing, counsel for the plaintiffs in the Jezarian action argued that all shareholders of Stirling Homex who acquired their shares between March 18, 1971, and July 10, 1972, a period during which the debtor issued false and misleading reports, should be treated as creditors on a parity with all other unsecured creditors (JA I 213, 214, 226, 227). 7/ Counsel also asserted that the bar order, 8/ requiring creditors to file their proofs of claim against the debtor by February 19, 1973, did not provide actual or adequate notice to stockholders who had been misled by those reports (JA I 213, 214, 217, 221-224).

6/ See Section 197 of Chapter X, 11 U.S.C. 597, and Chapter X Rule 10-302(a).

7/ Counsel for appellant Dixon also asserted that if stockholders were defrauded, they should participate on a parity with other unsecured creditors (JA I 236).

8/ That order is set forth at JA I 24-26.

court that, in his view, these claimants should not be able to "bootstrap themselves from the status of stockholders into the role of creditors, and if they are to become creditors in any sense of the term, * * * it should be decided that the conventional, * * * or the orthodox creditors, are in a class ahead of them" (JA I 250-251). Accordingly, the trustee noted that, in his opinion, it was not necessary to reach the question of whether the bar order had provided adequate notice (JA I 250).

The reorganization judge gave the parties a short period of time following the hearing to submit post-trial memoranda (JA I 264). Counsel for the plaintiffs in the Jezarian action and for the bank consortium submitted affidavits, each attaching additional information which they wished the judge to consider in arriving at his decision (JA II 269-400 and 401-439, respectively).

Counsel for the banks and for other unsecured creditors opposed parity treatment for defrauded stockholders, who, they claimed, only came forward after the trustee and the banks, with court approval on June 29, 1976 (JA I 140, 142-145), had reached a settlement of their dispute over whether the banks were secured or unsecured creditors (JA I 238, 240, 242, 244-245, 246). See page 4 n. 3, supra. Additionally, they argued that such claims should be excluded because of the bar order and, even if not, that they should be barred because of laches on the part of those making the claim (JA I 240, 242, 245, 247).

While the trustee was of the opinion that "the situation cried for a settlement," he desired a decision in order to avoid any further delay in consummating the reorganization proceeding (JA I 250). He advised the

On July 27, 1977, the reorganization judge issued his opinion and order (JA II 440-446), in which he concluded (JA II 446) that claims of alleged defrauded stockholders should be classified as subordinate to those of the conventional creditors. He recognized (JA II 443) the necessity for classifying creditors "for the purposes of the plan and its acceptance." In this connection, he noted that, since the "debtor has been adjudicated insolvent, [t]he only fair and equitable plan is one which would provide for orderly liquidation of the debtor's assets and a distribution of the proceeds among its creditors" (JA II 443-444, 445).

The judge found (JA II 444) that the stockholder fraud claims "are contingent and unliquidated" and those claimants may never become creditors. Further, he stated (id.) that a determination of those claims "involves serious factual and legal issues." He was of the view (id.) that "[i]f the claims of allegedly defrauded stockholders were not subordinated to the claims of conventional general unsecured creditors, a wholly new element will have been created in the financial structure of business." Because he believed creditors would no longer be able to extend credit and expect a priority over stockholders, he was of the opinion that "[s]uch a fundamental change" -- that is, recognizing the right of allegedly defrauded stockholders to be classified on a parity with general creditors -- required "legislation designed to overturn the long established rule of absolute priority" (id.).

In determining at the threshold that claims of allegedly defrauded stockholders should be subordinated to the claims of general creditors, the court below, as it had recognized at the hearing (JA I 224-225), did not have to reach the other issues raised by the parties, including whether the bar order in this case provided actual and adequate notice to the allegedly defrauded stockholders of Stirling Homex. Accordingly, in our view, the only issue before this Court on this appeal, and the only issue

we address in this brief, is the proper classification of allegedly defrauded stockholders. Should this Court reverse the district court and remand for a determination of the classification question based on the equities of this case, the district court then will have the opportunity to decide, in the first instance, the additional issues discussed in appellants' brief.

ARGUMENT

THE DISTRICT COURT ERRED AS A MATTER OF LAW IN APPLYING AN ABSOLUTE RULE AND SUBORDINATING CLAIMS OF STOCKHOLDERS PREMISED ON ASSERTED VIOLATIONS OF THE FEDERAL SECURITIES LAWS WITHOUT CONSIDERING THE MERITS OF THOSE CLAIMS AND ALL THE CIRCUMSTANCES SURROUNDING THIS CASE.

Among the special responsibilities with which a Chapter X court expressly is charged are dividing creditors "into classes according to the nature of their respective claims * * *" for "purposes of the plan and its acceptance" (Section 197), and finding, as a condition to approval and confirmation of any reorganization plan, that the plan is "fair and equitable" (Sections 174 and 221(2), 11 U.S.C. 574 and 621(2)).

Proper classification of creditors affects compliance with Section 179 of Chapter X, 11 U.S.C. 579, and Chapter X Rule 10-305(e), which require acceptance of an approved reorganization plan by the requisite majority of each affected class computed on the basis of allowed claims. Claimants with different legal rights are not classified together. ^{9/} A plan, such as the one to be formulated in the instant case, cannot be found to be "fair and equitable" unless it provides for full compensation to senior classes before junior classes may participate. The "fair and equitable" standard incorporates the absolute priority rule. Case v. Los Angeles Lumber Products Co., 308 U.S. 106, 115-122 (1939); Consolidated Rock Products Co. v. DuBois, 312 U.S. 510 (1941); Protective Committee v.

^{9/} 6A Collier on Bankruptcy 216-219, 220-224 (14th ed., 1976).

Anderson, 390 U.S. 414 (1968). Claims of an equal nature must be paid on an equal basis. Departures from that rule necessarily involve a transfer of part of a creditor's potential recovery to someone else.

A court's responsibility in this regard is not a "mere formality", but like "every important determination in reorganization proceedings, it calls for an informed, independent judgment." Protective Committee v. Anderson, supra, 390 U.S. at 424; Case v. Los Angeles Lumber Products Co., supra, 308 U.S. at 115. The Supreme Court stated in Case (308 U.S. at 114) that "[a]ll those interested in the estate are entitled to the court's protection." Accord, Comstock v. Group of Institutional Investors, 335 U.S. 211, 226-227 (1948).

The claims of allegedly defrauded stockholders in the instant case are premised, inter alia, on Sections 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a); Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Commission Rule 10b-5, 17 CFR 240.10b-5; and Section 13(a) of the Securities Exchange Act, 15 U.S.C. 78m(a), and the rules thereunder, 17 CFR 240.13a-1, 240.13a-10 and 240.13a-13. As noted (page 5 n. 5 and page 6, supra), stockholders of Stirling Homex have alleged in a consolidated class action and subsequently in the reorganization court that the debtor, among other things, published false and misleading financial reports, and (JA I 27-29, 211, 219) that purchasers of debtor's stock relied upon that false information to their substantial damage.

Section 106(4) of Chapter X, 11 U.S.C. 506(4), defines "creditor" to mean "the holder of any claim"; and Section 106(1), 11 U.S.C. 506(1), defines "claims" to "include all claims of whatever character against a debtor or its property * * * whether secured or unsecured, liquidated or unliquidated, fixed or contingent." Thus persons holding claims against the debtor based upon alleged securities fraud practiced upon them by the debtor fall within this broad definition.

The court below, without disagreeing that claims of defrauded stockholders may be valid claims, assumed that these claims are subordinate to claims of general creditors. For this, the court cited no reason other than that such claims "are contingent and unliquidated," that their determination will "involve[] serious factual and legal issues," and that, in any event, their recognition on a parity with claims of general creditors would create a fundamental change in corporate finance that should only be accomplished by "legislation designed to overturn" the absolute priority rule (JA II 444). Those reasons are the ones generally cited in favor of compromising such claims. 10/ We submit that they are invalid reasons outside of a compromise. Cf. Consolidated Rock Products Co. v. DuBois, supra, 312 U.S. at 520. 11/

Although the claims involved in this appeal "are contingent and unliquidated" at this time, as the reorganization judge noted (JA II 444), we submit that, in light of the information available to the court, 12/ it appears that the allegedly defrauded stockholders would be able to prove their claims, and that the test is not whether it would be difficult for the court to

10/ See, e.g., Protective Committee v. Anderson, supra, 390 U.S. at 424-425, 434, 437, 440-441; In re Equity Funding Corp. of America, 416 F. Supp. 132, 150-152, 153 (C.D. Cal., 1975).

11/ The Supreme Court there noted that it was error for a district court to confirm a reorganization plan that, among other things, provided for the cancellation of a claim because that court "made no findings as respects the amount or validity of that * * * claim; [and] it summarily disposed of it * * *."

12/ This includes the reports of the Commission, the consolidated class action, the trustee's report under Section 167(1) of Chapter X, and the criminal prosecution of certain officers and directors of Stirling Homex (see pages 4-5 and nn. 4-5).

determine the factual and legal issues. 13/ For the reasons set forth below, we submit that the district court erred as a matter of law in subordinating these fraud claims based on the record before it. 14/

We recognize the desire of the district court and the trustee to conclude this proceeding, which has been going on for some five and one-half years, and to pay the debtor's creditors as promptly as possible (see JA I 250), but "the need for expedition [of a protracted reorganization proceeding] is not a justification for abandoning proper standards." Protective Committee v. Anderson, supra, 390 U.S. at 450. See also In re William Rakestraw Co., 450 F.2d 6, 9 (C.A. 9, 1971).

This is not to say that claims may never be subordinated. The bankruptcy court, as a court of equity, 15/ may subordinate claims on equitable grounds. That power, though broad, 16/ is not unlimited. 17/ Thus claims of a controlling

13/ The instant case is thus distinguishable from In re Cartridge Television, Inc., 535 F.2d 1388 (C.A. 2, 1976), a straight bankruptcy case, in which this Court held that a bankruptcy judge had not abused his discretion in disallowing, pursuant to Section 57(d) of the Bankruptcy Act, 11 U.S.C. 93(d), similar claims that he found "to be too contingent and remote to be allowable." Id. at 1391. As noted (page 10, supra, Chapter X includes a more expansive definition of claims that specifically includes contingent and unliquidated claims. Doubt also has been cast upon the applicability of Section 57(d) to Chapter X in light of its apparent inconsistency with Section 196, 11 U.S.C. 596. See 6A Collier on Bankruptcy 135 n. 21, 170 n. 19 (14th ed., 1976).

14/ Where an order, such as the one involved in this appeal, is based upon a misperception of the law, a determination of its correctness on appeal is not governed by the "clearly erroneous" standard. Mamiye Bros. v. Barber Steamship Lines, Inc., 360 F.2d 774, 777 (C.A. 2), certiorari denied, 385 U.S. 835 (1966); cf. Securities and Exchange Commission v. Bausch & Lomb Inc., [Current] CCH Fed. Sec. L. Rep. ¶96,186 at p. 92,351 (C.A. 2, 1977).

15/ Local Loan Co. v. Hunt, 292 U.S. 234, 240 (1934); Pepper v. Litton, 308 U.S. 295, 304, 307 (1939); In re Branding Iron Steak House, 536 F.2d 299, 302 (C.A. 9, 1976).

16/ Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 219 (1941).

17/ In re Ahlswede, 516 F.2d 784, 787 (C.A. 9), certiorari denied sub nom. Stebbins v. Crocker-Citizens National Bank, 423 U.S. 913 (1975).

person may be subordinated to those of other claimants against a company if the controlling person has mismanaged that company to the injury of other claimants and investors. ^{18/} Or where sums are advanced as subordinated capital for the protection of other creditors, those providing such funds will not be permitted to share on a parity with the creditors for whose protection the money was paid, even though the debtor may have induced the contribution of the subordinated capital through fraud. In re Weis Securities, Inc., 425 F. Supp. 212, 216-217 (S.D. N.Y., 1977), appeal sub judice, C.A. 2, No. 77-6034, et al.

In the instant case, the fact that claims of defrauded stockholders arose under different circumstances from the claims of other unsecured creditors does not require separate classification. In re Los Angeles Land and Investments, Ltd., 282 F. Supp 448, 453-454 (D. Hawaii, 1968), aff'd on other grounds, 447 F.2d 1366 (C.A. 9, 1971); cf. J.P. Morgan & Co. v. Missouri Pac.R. Co., 85 F.2d 351, 352 (C.A. 8), certiorari denied, 291 U.S. 604 (1936). While there may be circumstances whereby the equities would require that defrauded stockholders not be treated on a parity with general creditors, as where stockholders purchasing their stock know that creditors are to be induced

^{18/} See, e.g., Taylor v. Standard Gas & Electric Co., 306 U.S. 307 (1939); Columbia Gas & Electric Corp. v. United States, 151 F.2d 461 (C.A. 6, 1945), petition for rehearing and modification denied, 153 F.2d 101 (C.A. 6, 1946), where the court in subordinating claims to those of all other creditors of a holding company and its subsidiaries, found that the claimant's primary purpose in acquiring bonds and stock of a debtor was to restrain actual and potential competition in the natural gas industry and to maintain claimant's monopolistic position in geographic area.

See also Pepper v. Litton, supra, 308 U.S. 295; Consolidated Rock Products Co. v. DuBois, supra, 312 U.S. at 522-524; Comstock v. Group of Institutional Investors, 335 U.S. 211, 229 (1948); American United Mutual Life Insurance Co. v. City of Avon Park, 311 U.S. 138, 145 (1940).

are to be induced to lend the debtor money in part by reason of the debtor's equity cushion, 19/ there is no record in this case to support such a finding.

Unless barred by a statute of limitations or by laches, these claimants are entitled to an opportunity to prove their case and right to participate on a parity with other unsecured creditors under the debtor's plan of liquidation (JA I 174, 203, 211, 221; JA II 267). 20/

While the Supreme Court has not dealt directly with the question of whether claims of defrauded stockholders are entitled to be treated on a parity with claims of general creditors in the context of a Chapter X reorganization proceeding, 21/ it has held that stockholders' rescission claims in insolvency proceedings are entitled to parity status with the claims of creditors.

Oppenheimer v. Harriman National Bank & Trust Co., 301 U.S. 206 (1937). In that case, a defrauded stockholder instituted suit against a bank, which had ceased operations, "to recover damages upon an executed rescission of a sale

19/ This Court has stated in this connection that "[r]eliance may become a relevant factor where equitable considerations require its consideration." In re Credit Industrial Corp., 366 F.2d 402, 409 (1966).

20/ In its order declaring Stirling Homex insolvent (JA II 266), the court below recognized (JA II 267) that a liquidation plan may be presented in Chapter X. Indeed, Section 216 of Chapter X, 11 U.S.C. 616, provides in pertinent part:

"A plan of reorganization under this chapter --

* * *

(10) shall provide means for the execution of the plan, which may include: * * * the distribution of * * * the proceeds derived from the sale [of assets], among those having an interest therein * * *."

21/ In reversing orders which had approved and confirmed a Chapter X plan of reorganization, the Court stated in Protective Committee v. Anderson, supra, 390 U.S. at 453, that it need not consider the issue there involved respecting "stockholders' claim under the federal securities laws."

to him of stock of the bank by means of fraudulent representations made by its president and vice president." Id. at 208. The Supreme Court, considered the question " * * * whether plaintiff's judgment is entitled to share equally in the receivership estate with other unsecured creditors' claims" (id. at 213-214). On this issue, the Court held (id. at 215):

"Discrimination against their claims is not authorized by the statute [authorizing assessments of stockholders of national banks]. It follows that plaintiff's judgment is entitled to rank on a parity with other unsecured creditors' claims."

For this proposition the Supreme Court cited with approval two cases, Clark v. Boston-Continental National Bank, 84 F.2d 605, 607 (C.A. 1, 1936), and Salter v. Williams, 244 Fed. 126 (C.A. 3, 1917), appeal dismissed, 250 U.S. 653 (1919). The court in Clark had stated that it could "see no reason why the plaintiffs [who had been induced to purchase bank stock by fraud chargeable to the bank] should not participate ratably with other creditors in the distribution of the bank's assets in the hands of the receiver." 84 F.2d at 607. Salter made clear that the claim for rescission did not have to be made before the receivership was instituted, and, since the right to rescind in that case was fixed when the fraud was practiced, the plaintiff was like any ordinary creditor whose claim arose prior to the receivership. 244 Fed. 130. 22/

22/ See also Fleeger v. Ames, 120 F.2d 803, 805 (C.A. 10, 1941), where preferred stockholders, who had been fraudulently induced to exchange their shares for common stock ten years earlier, filed fraud claims in a corporate reorganization under former Section 77B (the predecessor of Chapter X) and were restored to their status as preferred stockholders. And see Securities and Exchange Commission v. Insurance Investors Trust Co., [1971-72 Transfer Binder] CCH Fed. Sec. L. Rep. ¶93,259 (W.D. Ky., 1971), where, in a receivership ancillary to a Commission injunctive action, claims of allegedly defrauded stockholders were classified as general creditor claims and were entitled to parity with claims of other unsecured creditors in any distribution of assets in the receivership estate. Cf. In the Matter Los Angeles Land and Investments, Ltd., 282 F. Supp. 448 (D. Hawaii, 1968), aff'd on other grounds, 447 F.2d 1366 (C.A. 9, 1971).

While the foregoing cases involved insolvency proceedings under the National Bank Act (12 U.S.C. 21, et seq.), there is no reason why the holdings are not equally applicable here. The fact that, when the Oppenheimer case was decided, stockholders of national banks were individually liable to creditors upon the insolvency of a bank for up to the par value of their stock would give, if anything, additional force to the argument that the creditors had a right to look to the debtor's capital for the payment of their debts -- an argument specifically rejected in these cases. 23/

There is nothing in the Securities Act of 1933 (15 U.S.C. 77a, et seq.), the Securities Exchange Act of 1934 (15 U.S.C. 78a, et seq.), nor the Bankruptcy Act that compels a contrary result in the instant case. Indeed, a comparison of the National Bank Act with Chapter X reinforces the conclusion that claims of defrauded stockholders deserve similar equality of treatment in proceedings under Chapter X. While the National Bank Act provides for a "ratable" distribution of assets and Chapter X of the Bankruptcy Act provides for a distribution that is "fair and equitable" (Sections 174 and 221(2)), both statutes are governed by equitable considerations. Compare, e.g., American Surety Co. v. Bethlehem Bank, 314 U.S. 314, 316 (1941), with, e.g., Pepper v. Litton, supra, 308 U.S. at 304-305, 307-308. Accordingly, under both statutes, the ultimate standard is one of an equitable distribution of assets.

Claims of defrauded stockholders have a substantial legal foundation 24/

23/ See, e.g., Salter v. Williams, supra, 244 Fed. at 129.

24/ See, e.g., In re Cartridge Television, Inc., 535 F.2d 1388, 1391 (C.A. 2, 1976); In re Credit Industrial Corp., supra, 366 F.2d at 411-412; In re Associated Gas & Electric Co., 149 F.2d 996, 1009 (C.A. 2), certiorari denied sub nom. Elias v. Clarke, 326 U.S. 736 (1945); In re Four Seasons Nursing Centers of America, Inc., 472 F.2d 747, 749 (C.A. 10, 1973).

and have been recognized by a number of courts. ^{25/} Treatment of such claims on a parity with those of general creditors is consistent with the broad, remedial purposes of the federal securities laws and with the admonition of the Supreme Court that "it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose . . . [and] 'to adjust their remedies so as to grant the necessary relief' where federally secured rights are invaded." J. I. Case Co. v. Borak, 377 U.S. 426, 433 (1964).

As we have demonstrated, there is no absolute rule, as the reorganization judge applied in this case, that claims of defrauded stockholders should be classified as subordinate to those of general creditors in a Chapter X reorganization. Rather, the classification should be determined by the equities present in the particular case. In re Four Seasons Nursing Centers of America, Inc., 472 F.2d 747, 749 (C.A. 10, 1973).

^{25/} E.g., In re Four Seasons Nursing Centers of America, Inc., supra, 472 F.2d 747; In re Equity Funding Corp. of America, supra, 416 F. Supp. at 150-152; cf. Securities and Exchange Commission v. Insurance Investors Trust Co., supra, [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶93,259.

CONCLUSION

For the foregoing reasons, the order under review should be reversed and the case should be remanded with instructions that the classification of defrauded stockholders should be decided on the equities presented by this case.

Respectfully submitted,

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December 1977

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Nos. 77-5019 and 77-5022
(consolidated)

In the Matter of
STIRLING HOMEX CORPORATION

Debtor,

GREGORY JEZAPIAN, et al.,

Appellants.

CERTIFICATE OF SERVICE

I certify that on December 14, 1977, I caused two copies of the BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE, IN SUPPORT OF REVERSAL OF JUDGMENT BELOW to be served by mail, postage, prepaid upon the following:

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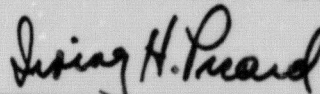
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